

General Information Letter: Treatment of Qualified Subchapter S Subsidiaries and Electing Small Business Trusts.

February 20, 1998

Dear:

This is in response to your letter dated February 18, 1998, in which you request a letter ruling. Department of Revenue ("Department") regulations require that the Department issue only two types of letter rulings, Private Letter Rulings ("PLRs") and General Information Letters ("GILs"). PLRs are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. GILs do not constitute statements of agency policy that apply, interpret or prescribe the tax laws and are not binding on the Department. For your general information we have enclosed a copy of 2 Ill. Adm. Code Part 1200 regarding rulings and other information issued by the Department.

Although you have not specifically requested either type of ruling, the nature of your question and the information provided require that we respond only with a GIL.

In your letter you have stated the following:

FACTS:

In 1996, the taxpayer filed a consolidated federal and state income tax returns with seven wholly owned subsidiaries. The parent company is the management company and is based in Illinois. There are two subsidiaries (Illinois and xxxxxxxx) which are food product manufacturers. The third subsidiary is a transportation company based in Illinois and delivering products to neighboring states. The fourth subsidiary manages operations of a food product manufacturer based in xxxxxxxxx. This subsidiary's income is from management fees. The fifth subsidiary has invested in a partnership based in xxxxxxxxxx. The final two subsidiaries are foreign entities and federal forms 5471 were filed for these entities in 19xx.

For the 1997 tax year, the taxpayer made a subchapter S election recognizing the wholly owned subsidiaries as qualified subchapter S subsidiaries.

The sole shareholder of the S corporation is an electing small business trust (ESBT). The ESBT has two 50% shareholders.

Issues:

- 1) Does the state recognize the federal QSSS election?
- 2) If the state recognizes the federal QSSS election, how should the transportation company be treated for apportionment purposes? Will assets be treated as based in the state where the garage is located?
- 3) What taxes, if any, are due at the subchapter S corporation level?
- 4) Are estimated tax payments due at the subchapter S corporation level?
- 5) Will the state recognize the federal ESBT election?
- 6) If the state recognizes the federal ESBT election, at what rate and on what account should the trust pay state taxes?

- 7) If the state recognizes the federal ESBT election, will the S corporation be required to withhold state income tax from any distributions made to the shareholder?
- 8) If the state recognizes the federal ESBT election, is the trust responsible for making quarterly estimated tax payments?

Ruling

Tax Treatment of Subchapter S Corporations

Section 201(a) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 5/101 et seq.) imposes the Illinois Income Tax on taxpayers earning or receiving income in or as a resident of Illinois. Pursuant to Section 201(b) of the IITA, this "regular income tax" is imposed at the rate of 3% of net income on individuals, trusts and estates and at the rate of 4.8% on corporations. Section 205(c) provides that "Subchapter S corporations" are exempt from the regular income tax.

Section 201(c) of the IITA imposes a Personal Property Tax Replacement Income Tax (generally referred to as the "replacement tax") on "every corporation (including Subchapter S corporations), partnership and trust" earning or receiving income in or as a resident of Illinois. For corporations other than Subchapter S corporations, the replacement tax is imposed at a rate of 2.5% of net income. For Subchapter S corporations, partnerships and trusts, the replacement tax rate is 1.5%. See Section 201(d) of the IITA.

"Net income" is computed in the same manner for both regular income tax and replacement tax purposes. The computation of net income begins with federal adjusted gross income for individuals and with federal taxable income for all other taxpayers. See Section 203 of the IITA. Accordingly, any income of a Subchapter S corporation included in the federal taxable income or federal adjusted gross income of one of its shareholders will be included in Illinois net income unless it is deducted or allocated or apportioned to another state under a specific statutory provision.

Section 803(a) of the IITA provides:

Every taxpayer other than an estate, trust, partnership, Subchapter S corporation or farmer is required to pay estimated tax for the taxable year, in such amount and with such forms as the Department shall prescribe, if the amount payable as estimated tax can reasonably be expected to be more than \$250 or \$400 for corporations.

Definition of "Subchapter S Corporation"

Section 1501(a)(28) of the IITA provides:

The term "Subchapter S corporation" means a corporation for which there is in effect an election under Section 1362 of the Internal Revenue Code . . .

Section 1362 of the Internal Revenue Code permits a "small business corporation" to elect taxation as a Subchapter S corporation. The term "small business corporation" is defined in Section 1361(b) of the Internal Revenue Code, which provides, in part:

(3) TREATMENT OF CERTAIN WHOLLY OWNED SUBSIDIARIES.-- (A) IN GENERAL.--For purposes of this title--

(i) a corporation which is a qualified subchapter S subsidiary shall not be treated as a separate corporation, and

(ii) all assets, liabilities, and items of income, deduction, and credit of a qualified subchapter S subsidiary shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation.

(B) QUALIFIED SUBCHAPTER S SUBSIDIARY.--For purposes of this paragraph, the term "qualified subchapter S subsidiary" means any domestic corporation which is not an ineligible corporation (as defined in paragraph (2)), if--

(i) 100 percent of the stock of such corporation is held by the S corporation, and

(ii) the S corporation elects to treat such corporation as a qualified subchapter S subsidiary.

Section 102 of the IITA provides:

Except as otherwise expressly provided or clearly appearing from the context, any term used in this Act shall have the same meaning as when used in a comparable context in the United States Internal Revenue Code of 1954 or any successor law or laws relating to federal income taxes and other provisions of the statutes of the United States relating to federal income taxes as such Code, laws and statutes are in effect for the taxable year.

Section 1501(a)(4) of the IITA provides:

The term "corporation" includes associations, joint-stock companies, insurance companies and cooperatives. Any entity, including a limited liability company formed under the Illinois Limited Liability company Act, shall be treated as a corporation if it is so classified for federal income tax purposes.

Pursuant to Section 1361(b)(3) of the Internal Revenue Code, a qualifying Subchapter S subsidiary ("QSSS") is not a separate corporation, but rather is defined to be a part of its parent Subchapter S corporation for all purposes of the Internal Revenue Code. Because this definition is expressly adopted by the IITA, a QSSS is not a separate corporation for Illinois income tax purposes. Instead, the QSSS is by definition part of its parent Subchapter S corporation, and its assets, liabilities, and items of income, deduction, and credit must be included with the assets, liabilities, and items of income, deduction, and credit of its parent Subchapter S corporation in determining the Illinois income tax liabilities of the parent and its shareholders.

Taxation of Electing Small Business Trusts

Section 1361 of the Internal Revenue Code allows only certain persons to be shareholders of a Subchapter S corporation. Section 1361(c)(2)(v) permits an "electing small business trust" ("ESBT") to be a shareholder of a Subchapter S corporation. Section 641(d) of the Internal Revenue Code provides that an ESBT which owns both Subchapter S corporation stock and other assets will be treated as two separate trusts: one comprised of all Subchapter S corporation stock owned by the ESBT and the other comprised of all other assets. Otherwise, an ESBT is taxable pursuant to the same rules governing other trusts.

Section 201(b)(3) of the IITA imposes the regular income tax on trusts at the rate of 3% of net income. Section 201(d) of the IITA imposes the replacement tax on trusts at the rate of 1.5% of net income. In each case, net income is determined under Section 203(c) of the IITA by starting with federal taxable income, and making specific additions and subtractions. As provided in Section 102 of the IITA, quoted above, the term "trust" has the same meaning under the IITA as it has under the Internal Revenue Code.

Section 803(a) of the IITA, quoted above, provides that trusts are not subject to payment of estimated taxes.

Application

Applying these statutory provisions to the facts described in your letter, the answers to your specific questions are as follows:

1) Does the state recognize the federal QSSS election?

For purposes of the IITA, a Subchapter S corporation and each QSSS owned by that corporation are treated as a single Subchapter S corporation.

2) If the state recognizes the federal QSSS election, how should the transportation company be treated for apportionment purposes? Will assets be treated as based in the state where the garage is located?

In order to determine what portion of a corporation's business income is subject to Illinois income taxation, Section 304 of the IITA provides different apportionment formulae for use by insurance companies, by financial organizations, by transportation companies, and by all other businesses. Because the Subchapter S corporation and each QSSS are treated as a single Subchapter S corporation, the transportation company will not be treated as a separate corporation for purposes of determining which apportionment formula to use. The Subchapter S corporation and its QSSS will determine which apportionment rules to use as if they were a single corporation.

3) What taxes, if any, are due at the subchapter S corporation level?

A Subchapter S corporation is subject to replacement tax at the rate of 1.5% of its net income, and is exempt from regular income tax. The parent corporation and its QSSS will compute the replacement tax liability as a single Subchapter S corporation.

4) Are estimated tax payments due at the subchapter S corporation level?

Section 803(a) of the IITA expressly excludes Subchapter S corporations from payment of estimated taxes.

5) Will the state recognize the federal ESBT election?

Yes.

6) If the state recognizes the federal ESBT election, at what rate and on what account should the trust pay state taxes?

In general, a trust will be subject to Illinois income taxation if it is subject to federal income taxation, because the computation of Illinois net income begins with the trust's federal taxable income. The one tax characteristic peculiar to an ESBT is that an ESBT may be treated as two separate trusts for federal income tax purposes if it owns assets other than stock in Subchapter S corporations, and an ESBT in that situation will be treated as two separate trusts for Illinois purposes as well. Trusts with net income are subject to regular income tax at 3% and replacement tax at 1.5% of that net income.

7) If the state recognizes the federal ESBT election, will the S corporation be required to withhold state income tax from any distributions made to the shareholder?

There is no provision in the IITA for withholding of state income taxes from distributions by a corporation to its shareholders.

8) If the state recognizes the federal ESBT election, is the trust responsible for making quarterly estimated tax payments?

Section 803 of the IITA expressly provides that trusts are not subject to payment of estimated taxes.

As stated above, this is a GIL which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you wish to obtain a PLR which will bind the Department with respect to the application of the law to specific facts, please submit a request conforming to the requirements of 2 Ill. Adm. Code Part 1200. Please note, however, that a PLR cannot apply the law to a hypothetical situation and a PLR is not binding with respect to a statement of facts which is incomplete or incorrect. Accordingly, the Department does not ordinarily issue PLRs in response to requests based on unsupported conclusions of fact or which are, in effect, requests for determinations of fact. Given the inherently factual nature of the issues in your inquiry, we believe it is unlikely that we will be able to issue a PLR in this instance.

Sincerely,

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